

Client Update

Financial Markets Developments

Repricing Underwater Stock Options

The sub-prime mortgage crisis and the resulting economic downturn have significantly impacted stock prices at a large number of companies. According to a recent report by Financial Week, stock options are underwater at nearly 40 percent of the Fortune 500 companies and one in every ten companies has options that are more than 50 percent underwater.¹ At the time the report was published, the Dow Jones Industrial Average was approximately 11,500. One of the most important strategic issues companies can face during a market downturn is how to address the fact that their stock option plans, which are intended to incentivize employees, have lost a critical element—incentive.

A stock option is considered to be “underwater” when its exercise price is higher than the market price of the underlying stock. There are a number of methods for addressing the problem of underwater options—each with its own benefits and drawbacks. Traditionally, the most common method has been “repricing” the options by lowering their exercise price. As discussed below, repricings now often take the form of a wide variety of different exchange programs, including programs that involve the issuance of different forms of equity compensation, such as restricted stock and restricted stock units (“RSUs”), in exchange for underwater options. What all repricings have in common, however, is the goal of reestablishing an incentive component for continued hard work and commitment, as well as restoring the retention capability of an employer’s equity compensation plan.

The last significant wave of repricings occurred in 2001 and 2002 as a result of the market downturn triggered by the collapse of internet and technology stocks. There have been significant regulatory, accounting and market practice developments as a result of lessons learned from that period. These developments resulted, in part, from a perception that some companies implemented option-repricing programs too quickly after announcing disappointing earnings followed by a subsequent drop in stock price. In addition, stock exchanges have since adopted rules requiring shareholder approval for option repricings, and institutional investors and proxy advisors, who advise shareholders on how to vote on repricing proposals, now exert a significant influence over the structuring of option repricings.

The issue of option repricings is likely to increase in importance during the last quarter of 2008 as companies consider items for inclusion in their 2009 proxy statements. If shareholder approval will be required to undertake a repricing (as is generally the case), companies with underwater options should consider now their strategy for addressing this challenge in connection with their annual meeting. Sufficient time should be allowed to obtain advice from

¹ See Mark Bruno, *Glub, glub, glub: 40% of options are underwater*, Financial Week, Aug. 25, 2008, at 1, 20, available at, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080825/REG/860774>.



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compensation consultants, advance review of option repricing proposals by proxy advisors and requisite compensation committee and board approvals. Companies may also want to consider now how to address underwater options so that they can condition their 2009 annual grant of options (or other securities) on employees relinquishing their underwater options. This approach will not remove the need for shareholder approval (if required) and a tender offer as described below, but it will likely reduce the compensation expense associated with the annual grant and will likely result in a larger number of underwater options being canceled.

Structuring Repricings

One-For-One Exchanges

Option repricings were traditionally effected by lowering the exercise price of underwater options to the then-prevailing market price of a company's common stock. Mechanically, this result was achieved either by amending the terms of the outstanding options or by canceling the outstanding options and issuing replacement options. The majority of repricings that occurred during the 2001 and 2002 market downturn were one-for-one option exchanges. At that time, the majority of new options had the same vesting schedule as the canceled options and only a minority of companies excluded directors and officers from repricings.²

Two subsequent developments have made one-for-one option exchanges the exception rather than the norm:

- In 2003, the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") adopted a requirement that public companies must seek shareholder approval of option repricings. As a result, companies must now ask (often unhappy) shareholders to provide employees with a benefit that the shareholders themselves will not enjoy. This development, coupled with the significant influence exerted on shareholder votes by institutional investors and proxy advisors, has made it almost impossible for companies to gain shareholder approval of a one-for-one option exchange due to perceived unfairness to shareholders.
- Prior to the effectiveness of FAS 123R, stock option grants were not accounted for as an expense on a company's income statement. As a result, provided a company waited six months and one day, there was a limited accounting impact from a significant grant of replacement stock options, giving stock options a distinct advantage over other forms of equity compensation. FAS 123R now requires the expensing of employee stock options over the implied service term (the vesting period of the options). As a result, FAS 123R increased the accounting cost of a one-for-one option exchange and generally eliminated any accounting advantage that stock options had over other forms of equity compensation.

Value-For-Value Exchanges

Companies seeking to reprice their options now often undertake a "value-for-value" exchange.³ A value-for-value exchange affords option holders the opportunity to cancel

2 In the past, the most significant complicating factor for repricings was unfavorable, variable, mark-to-market accounting treatment that resulted if the cancelation of outstanding options and the grant of new options occurred within six months of each other. This resulted from FASB Interpretation no. 44, *Accounting for Certain Transactions Involving Stock Compensation* (interpretation to APB Opinion No. 25, *Accounting for Stock Issued to Employees*), which became effective in July 2000. Therefore, prior to the adoption of FASB Statement No. 123 (revised 2004), *Share-Based Payment* ("FAS 123R"), companies had to wait six months and one day to replace canceled options in order to avoid this unfavorable accounting treatment. FAS 123R became effective for annual reporting periods beginning after June 15, 2005 for companies with revenues over US\$25 million and for annual reporting periods beginning after December 15, 2005 for other companies.

3 A one-for-one exchange may still be appropriate under certain circumstances. For example, the board of VMware, Inc., which undertook the largest IPO by a technology company in 2007, approved in August 2008, an exchange offer with respect to the options it granted after its IPO. The exchange ratio for US employees was one-for-one. The plan called for non-US employees to receive RSUs in exchange for their option. Directors and executive officers were excluded from the exchange program.

underwater options in exchange for an immediate regrant of new options at a ratio of less than one-for-one with an exercise price equal to the market price of such shares.

Value-for-value exchanges are more acceptable to shareholders and proxy advisors than one-for-one exchanges. A value-for-value exchange results in less dilution to public shareholders than a one-for-one exchange because it allows the reallocation of a smaller amount of equity to employees, which shareholders generally perceive as being fairer under the circumstances. In addition, the accounting implications of a value-for-value exchange are significantly more favorable than a one-for-one exchange. Under FAS 123R, the accounting cost of new options (amortized over their vesting period) is the fair value of those grants less the current fair value of the canceled (underwater) options. As a result, companies generally structure an option exchange so that the value of the new options for accounting purposes—based on Black-Scholes or another option pricing methodology—approximates or is less than the value of the canceled options. If the fair value of the new options exceeds the fair value of the canceled options, that incremental value is recognized over the remaining service period of the option holder.

Use of Restricted Stock or RSUs

A common variation of the value-for-value exchange is the cancelation of all options and the grant of restricted stock or RSUs (also called phantom shares or phantom units) with the same or a lower economic value than the options canceled. Restricted stock is stock that is generally subject to a substantial risk of forfeiture at grant but will vest upon the occurrence of certain time or performance-based conditions (or both). Restricted stock is nontransferable while it is forfeitable. RSUs are economically similar to restricted stock, but involve a deferred delivery of the shares until a time that is concurrent with, or after, vesting.

The US tax rules applicable to restricted stock are different from those applicable to RSUs. Although the taxation of

restricted stock is generally postponed until the property becomes vested, the grantee of restricted stock may elect to be taxed in the year of grant, rather than waiting until vesting. If this election is made pursuant to Section 83(b) of the Internal Revenue Code (“IRC”), the grantee is treated as receiving ordinary income equal to the fair market value of the underlying stock on the date of the grant. Future appreciation is taxed, as capital gain rather than as ordinary income, when the grantee disposes of the property. Because non-US jurisdictions do not generally have a provision equivalent to Section 83(b), many companies grant RSUs to their non-US employees because RSUs generally permit deferral of taxation until transfer of property under the RSU and therefore provide a similar tax consequence to restricted stock in the United States.

One benefit of both restricted stock and RSUs is that such awards ordinarily have no purchase or exercise price and provide immediate value to the grantee. Consequently, the exchange ratio will generally result in less dilution to existing stockholders than an option-for-option exchange. In addition, at a time when institutional investors and proxy advisors may advocate greater use of restricted stock and RSUs, either alone or together with stock options and Stock Appreciation Rights (SARs),⁴ such an exchange can be part of a shift in the overall compensation policy of a company. Finally, because restricted stock and RSUs ordinarily have no exercise price, there is no risk that they will subsequently go underwater if there is a further drop in a company’s stock price. This can be an important consideration in a volatile market.

Restricted stock and RSU grants can be structured to satisfy the performance-based compensation exception under Section 162(m) of the IRC, where applicable. Section 162(m) in general terms limits to US\$1 million per year the deductibility of compensation to a public corporation’s CEO and the next top three highest-compensated officers (other than the CFO), unless an exception applies. One such exception is for performance-based compensation, which generally includes stock options. As a result, the adoption of

⁴ SARs are essentially net options, and provide for the delivery, in cash or shares (as applicable), of an amount equal to the spread (i.e., the excess of fair market value over exercise price) upon exercise. Broker-assisted cashless exercises of options have an economic effect similar to that of SARs, but technically involve the payment of the exercise price to the issuer with a loan or other assistance from the broker.

this provision in 1993 had the unanticipated consequence of encouraging companies to use stock options instead of other forms of equity compensation.⁵ In addition, the rules regarding stock options under Section 162(m) are simpler than for other forms of performance-based compensation.

Repurchase of Underwater Options for Cash

Instead of an exchange, a company may simply repurchase underwater options from employees for an amount based on Black-Scholes or another option pricing methodology. The repurchase of underwater options generally involves a cash outlay by the company, the amount of which will vary based on the extent that the shares are underwater and to the extent that such repurchase is limited to fully-vested options. Such a repurchase would reduce the number of options outstanding as a percent of the total number of common shares outstanding (referred to as the “overhang”), which is generally beneficial to a company’s capital structure.

Treatment of Directors and Officers

Due to the guidelines of proxy advisors and the expectations of institutional investors, directors and executive officers are often excluded from participating in repricings that require shareholder approval. Nevertheless, because directors and executive officers often hold a large number of options, excluding them can undermine the goals of the repricing. As an alternative to exclusion, companies could permit directors and officers to participate on less favorable terms than other employees and could consider seeking separate shareholder approval for the participation of directors and officers in order to avoid jeopardizing the overall program. Where the method of repricing or the intention behind the implementation of a new program reflects a shift in the overall compensation policy of a company, such as the exchange of options for restricted stock or RSUs, proxy advisors and institutional investors are more likely to acquiesce in the inclusion of directors and executive officers.

Key Repricing Terms

The following are key terms that a company conducting a repricing will need to consider. It is advisable to retain a compensation consultant to assist with these matters and implementation of the program:

Exchange Ratio. The exchange ratio for an option exchange represents the number of options that must be tendered in exchange for one new option or other security. This must be set appropriately in order to encourage employees to participate and to satisfy shareholders. In order for a repricing to be value neutral, there will usually be a number of exchange ratios, each addressing a different range of option exercise prices.

Option Eligibility. The company must determine whether all underwater options, or only those that are significantly underwater, are eligible to be exchanged. This will depend on the volatility of the company’s stock and on the company’s expectations of future increases in share price.

New Vesting Periods. A company issuing new options in exchange for underwater options must determine whether to grant the new options based on a new vesting schedule, the old vesting schedule or a schedule that provides some accelerated vesting between these two alternatives.

Shareholder Approval

NYSE and Nasdaq Requirements

As a result of rules adopted in 2003 by the NYSE and Nasdaq requiring shareholder approval for any material amendment to an equity compensation program, a company listed on the NYSE or Nasdaq must first obtain shareholder approval of a proposed repricing unless the equity compensation plan under which the options in question were issued expressly permits the company to reprice outstanding options.⁶ NYSE and Nasdaq

⁵ Section 162(m) was enacted following Congress’ examination of, among other things, how to control executive compensation, which examination resulted in the widespread use of stock options rather than other forms of equity compensation. Commentators have noted the irony that the increased use of stock options is one factor that resulted in the recent significant escalation of executive compensation.

⁶ NYSE, Inc. Listed Company Manual, Section 303A(8); Nasdaq Rule 4350(i) and Nasdaq, Interpretive Manual IM-4350-5. See the American Stock Exchange Company Guide Section 711 and related commentary.

rules define a material amendment to include any change to an equity compensation plan to “permit a repricing (or decrease in exercise price) of outstanding options. . . [or] reduce the price at which shares or options to purchase shares may be offered.”⁷ A plan that does not contain a provision that specifically permits repricing of options will be considered to prohibit repricing for purposes of the NYSE and Nasdaq rules.⁸ Therefore, even if a plan itself is silent as to repricing, any repricing of options under that plan will be deemed to be a material revision of the plan requiring shareholder approval. In addition, shareholder approval is required before deleting or limiting a provision in a plan prohibiting the repricing of options.⁹

The NYSE and Nasdaq define a repricing as involving any of the following:¹⁰

- (i) lowering the strike price of an option after it is granted;
- (ii) canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock or other equity, unless the cancelation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction; and
- (iii) any other action that is treated as a repricing under generally accepted accounting principles.

It should be noted that neither the NYSE nor Nasdaq rules prohibit the straight repurchase of options for cash. Nasdaq has provided an interpretation stating that the repurchase of outstanding options for cash by means of a tender offer does not require shareholder approval even if an equity compensation plan does not expressly permit such a repurchase.¹¹ In reaching this conclusion, Nasdaq noted that the consideration for the repurchase was not equity. As noted below, however, some

proxy advisors may still require shareholder approval for a cash repurchase program.

Shareholder approval of a repricing will likely be required for most domestic companies listed on the NYSE or Nasdaq since they are unlikely to expressly permit a repricing. A discussion regarding the exception available to foreign private issuers is provided below.

Proxy Advisors and Institutional Investors

Leading proxy advisors have taken a clear position on repricing provisions in equity compensation plans. The proxy advisor market is dominated by Institutional Shareholder Services (“ISS”), a division of RiskMetrics Group. Other significant proxy advisors include Glass Lewis, Egan-Jones and Proxy Governance.

While ISS and Glass Lewis each publish detailed voting guidelines related to option repricing, Egan-Jones’ voting guidelines state that it will consider repricing proposals on a case-by-case basis without enumerating its considerations. Proxy Governance considers all matters on a case-by-case basis and does not publish voting guidelines.

ISS and Glass Lewis both expressly state in their proxy voting guidelines that they will recommend that shareholders vote against any equity compensation plan that permits repricing without a shareholder vote.¹² ISS’s 2008 US Proxy Voting Guidelines further state that ISS will recommend that shareholders vote against or withhold their vote from members of a company’s compensation committee if that company repriced underwater options for stock, cash or other consideration without prior shareholder approval, even if such a repricing is permitted under the company’s equity compensation plan. Against this background, it is likely that most companies will seek shareholder approval for a repricing even if it is not required under their equity compensation plans.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ NYSE, Inc., Listed Company Manual Section 303A(8); Nasdaq, Frequently Asked Questions, <http://www.nasdaq.com/about/FAQsCorpGov.stm#12D2>.

¹¹ Nasdaq Staff Interpretive Letter 2004-21, available at http://www.nasdaq.com/about/StaffInterpretiveLetters_2004.pdf.

¹² See Glass Lewis & Co., Proxy Paper Policy Guidelines for US Companies, An Overview of the Glass Lewis Approach to the Voting at US Company Shareholder Meetings (2008), available at <http://www.glasslewis.com/downloads/policies/USPolicyGuidelinesSummary2008.pdf>, and RiskMetrics Group_2008 US ProxyVoting Guidelines Summary, ISS Governance Services, Dec. 17, 2007, available at <http://www.issproxy.com/pdf/2008PolicyUSSummaryGuidelines.pdf>.

In February 2007, ISS updated its guidance regarding repricings, stating that it would recommend a vote in favor of a management proposal to reprice options on a case-by-case basis taking into consideration the following factors:¹³

- Historic trading patterns—the stock price should not be so volatile that the options are likely to be back “in-the-money” over the near term.
- Rationale for the repricing—was the stock price decline beyond management’s control?
- Type of exchange—is this a value-for-value exchange?
- Burn rate—are surrendered stock options added back to the plan reserve?
- Option vesting—do the new options vest immediately or is there a black-out period?
- Term of the option—does the term remain the same as that of the replaced option?
- Exercise price—is the exercise price set at fair market or a premium to market?
- Participants—executive officers and directors should be excluded.

As part of its update, ISS stated that it would evaluate the “intent, rationale and timing” of the repricing proposal, noting that it would consider the repricing of options after a recent precipitous drop in a company’s stock price to be poor timing. ISS also noted that the decline in stock price should not have occurred within the year immediately prior to the repricing and that the grant dates of the surrendered options should be far enough back (two to three years) so as not to suggest that repricings were being commenced to take advantage of short-term downward price movements. Finally, ISS requires that the exercise price of the surrendered options be above the 52-week high for the stock price.

Glass Lewis states in its guidelines that it will recommend a vote in favor of a repricing proposal on a case-by-case basis if:

- Officers and board members do not participate in the repricing.
- The stock decline mirrors the market or industry price decline in terms of timing and approximates the decline in magnitude.
- The repricing is value neutral or value creative to shareholders with very conservative assumptions and a recognition of the adverse selection problems inherent in voluntary programs.
- Management and the board make a cogent case for needing to incentivize and retain existing employees, such as being in a competitive employment market.

Treatment of Canceled Options

Upon the occurrence of a repricing, equity compensation plans generally provide for one of two alternatives: (i) the shares underlying repriced options are returned to the plan and used for future issuances or (ii) such shares are redeemed by the company and canceled, so as to no longer be available for future grants. A company’s equity compensation plan should make clear which alternative it will use. In the case of an option repricing that results in the return of canceled shares to a company’s equity incentive plan, ISS considers whether the issuer’s three-year average burn rate is acceptable in determining whether to recommend that shareholders approve the repricing.¹⁴

Proxy Solicitation Methodology

Companies seeking shareholder approval for a repricing face a number of hurdles, not the least the fact that shareholders have suffered from the same decrease in share price that caused the options to fall underwater. It should also be noted that brokers are prohibited from exercising discretionary voting

¹³ Institutional Shareholder Services, US Corporate Governance Policy 2007 Updates, Nov. 5, 2006, <http://www.issproxy.com/pdf/2007%20US%20Policy%20Update.pdf> (effective for meetings after February 1, 2007).

¹⁴ Under ISS guidelines, annual burn rate = (# of options granted + # of full value shares awarded * Multiplier) / (Weighted Average common shares outstanding). ISS will generally recommend a vote against an equity incentive plan or a repricing proposal where canceled options are returned to the plan if the company’s most recent three-year burn rate exceeds one standard deviation in excess of the industry mean (based on a table prepared by ISS) and is over two percent of common shares outstanding. We note that shares underlying repriced options count against a plan’s limit on option grants to an individual employee during a specific period of time.

power (i.e., to vote without instructions from the beneficial owner of a security) with respect to implementation of, or a material revision to, an equity compensation plan.¹⁵ Therefore, the need to convince shareholders of the merits of a repricing is magnified, as is the influence of proxy advisors.

The solicitation of proxies from shareholders by a domestic reporting company is governed by Section 14(a) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) and the rules thereunder. Item 10 of Schedule 14A contains the basic disclosure requirements for a proxy statement used by a domestic issuer to solicit approval of a repricing. Pursuant to these requirements and common practice, issuers generally include the following items of disclosure:

- A description of the option exchange program, including a description of who is eligible to participate, the securities subject to the exchange offer, the exchange ratio and the terms of the new securities.
- A table disclosing the benefits or amounts, if determinable, that will be received by or allocated to (i) named executive officers, (ii) all current executive officers as a group, (iii) all current directors who are not executive officers as a group and (iv) all employees, including all current officers who are not executive officers, as a group.
- A description of the reasons for undertaking the exchange program and any alternatives considered by the board.
- The accounting treatment of the new securities to be granted and the US federal income tax consequences.

It is important that companies ensure that their disclosure includes a clear rationale for the repricing in order to satisfy the disclosure requirements sought by proxy advisors and necessary to persuade shareholders to vote in favor of the repricing.¹⁶

Rule 14a-6 under the Exchange Act permits a company that is soliciting proxies solely for certain specified limited purposes in connection with its annual meeting (or a special meeting in lieu of an annual meeting) to file a definitive proxy statement with the SEC and commence its solicitation immediately. The alternative requirement would be to file a preliminary proxy statement first and wait ten days while the SEC determines if it will review and comment on the proxy statement. While there is some room for interpretation, we believe that the better position is that a proxy statement containing a repricing proposal should generally be filed with the SEC in preliminary form and then in definitive form after ten days if there is no SEC review. This is because the purposes for which a proxy statement can be initially filed in definitive form are limited to the following solely in connection with an annual meeting: (i) the election of directors, (ii) the election, approval or ratification of accountants, (iii) a security holder proposal included pursuant to Rule 14a-8 and (iv) the approval, ratification or amendment of a “plan.” “Plan” is defined in Item 401(a)(6)(ii) of Regulation S-K as “any plan, contract, authorization or arrangement, whether or not set forth in any formal document, pursuant to which cash, securities, similar instruments, or any other property may be received.” Most repricing proposals could be viewed as seeking approval of an amendment to a company’s plan to permit the repricing and approval of the terms of the repricing itself. The better interpretation seems to be that approval of the terms of a particular repricing is separate from an amendment to the plan to permit repricing since the repricing terms would generally still be submitted for shareholder approval due to proxy advisor requirements even if the plan permitted repricing. Accordingly, companies should initially file proxy statements for a repricing in preliminary form.

¹⁵ See NYSE Rule 452.

¹⁶ It is worth noting that Item 402(d) of Regulation S-K requires that any repricing of an option held by a director or named executive be disclosed in a company’s annual proxy statement for the election of directors. See also Securities and Exchange Commission, Division of Corporation Finance, Current Issues and Rulemaking Projects Quarterly Update (Mar. 31, 2001), Part II.

Tender Offer Rules

Application of the Tender Offer Rules

US tender offer rules are generally implicated when the holder of a security is required to make an investment decision with respect to the purchase, modification or exchange of that security. One might question why a unilateral reduction in the exercise price of an option would implicate the tender offer rules since there is no investment decision involved by the optionholder. Indeed, many equity incentive plans permit a unilateral reduction in the exercise price of outstanding options, subject to shareholder approval, without obtaining the consent of optionholders on the basis that such a change is beneficial to them. In reality, however, the likelihood of a domestic company being able to conduct a repricing without implicating the tender offer rules is minimal for the following reasons:

- Because of the influence of proxy advisors and institutional shareholders, most option repricings involve a value-for-value exchange consisting of more than a mere reduction in exercise price. A value-for-value exchange requires a decision by optionholders to accept fewer options or to exchange existing options for restricted stock or RSUs. This is an investment decision requiring the solicitation and consent of individual optionholders.
- A reduction in the exercise price of an Incentive Stock Option (“ISO”) would be considered a “modification” akin to a new grant under applicable tax laws.¹⁷ The new grant of an ISO restarts the holding periods required for beneficial tax treatment of shares purchased upon exercise of the ISO. The holding periods require that the stock purchased under an ISO be held for at least two years following the grant date, and one year following the exercise date, of the option. The resulting investment decision makes it difficult in practice to effect a repricing that includes ISOs without seeking the consent of ISO holders since they must decide

if the benefits of the repricing outweigh the burdens of the new holding periods.

The SEC staff has suggested that a limited option repricing/exchange with a small number of executive officers would not be a tender offer. In such an instance, the staff position is that an exchange offer to a small group is generally seen as equivalent to individually-negotiated offers, and thus not a tender offer. Such an offer, in many respects, would be similar to a private placement. The SEC staff believes that the more sophisticated the optionholders, the more the repricing/exchange looks like a series of negotiated transactions. However, the SEC staff has not provided guidance on a specific number of offerees so this remains a facts and circumstances analysis based on both the number of participants, and their positions and sophistication.¹⁸

Not all equity incentive plans involve the issuance ISOs and thus the attendant ISO-related complexities will not always apply. As a result, foreign private issuers and domestic companies that have not granted ISOs and are simply reducing the exercise price of outstanding options unilaterally may also be able to avoid the application of the US tender offer rules. Foreign private issuers are discussed in more detail below.

Requirements of the US Tender Offer Rules

The SEC views a repricing of options that requires the consent of the optionholders as a “self tender offer” by the issuer of the options. Self tender offers by companies with a class of securities registered under the Exchange Act are governed by Rule 13e-4 thereunder, which contains a series of rules designed to protect the interests of the targets of the tender offer. While Rule 13e-4 applies only to public companies, Regulation 14E applies to all tender offers. Regulation 14E is a set of rules prohibiting certain practices in connection with tender offers and requiring, among other things, that a tender offer remain open for at least 20 business days.

¹⁷ For ISO purposes, a modification is any change in the terms of the option that gives the optionee additional benefits under the option, regardless of whether the optionee actually benefits from such change. Treas. Reg. Section 1.424-1(e)(4).

¹⁸ American Bar Association, Technical Session Between the SEC Staff and the Joint Committee on Employee Benefits, Question and Answers, May 8, 2001, available at http://www.thecorporatecounsel.net/member/FAQ/employeebenefits/01_JCEB.htm.

In March 2001, the SEC issued an exemptive order providing relief from certain tender offer rules that the SEC considered onerous and unnecessary in the context of an option repricing.¹⁹ Specifically, the SEC provided relief from complying with the “all holders” and “best price” requirements of Rule 13e-4. As a result of this relief, issuers are permitted to reprice/exchange options for selected employees. Among other things, this exception allows issuers to exclude directors and officers from repricings. Furthermore, issuers are not required to provide each optionholder with the highest consideration provided to other optionholders.²⁰

Pre-commencement offers. The tender offer rules regulate the communications that a company may make in connection with a tender offer. These rules apply to communications made before the launch of a tender offer and during its pendency. Pursuant to these rules, a company may publicly distribute information concerning a contemplated repricing before it formally launches the related tender offer, provided that the distributed information does not contain a transmittal form for tendering options or a statement of how such form may be obtained. Two common examples of company communications that fall within these rules are the proxy statement seeking shareholder approval for a repricing and communications between the company and its employees at the time that proxy statement is filed with the SEC. Each such communication is required to be filed with the SEC under cover of a Schedule TO with the appropriate box checked indicating that the content of the filing includes pre-commencement written communications.

Tender offer documentation. An issuer conducting an option exchange will be required to prepare the following documents:

- Offer to exchange, which is the document pursuant to which the offer is made to the company’s optionholders and which must contain the information required to be included therein under the tender offer rules.
- Letter of transmittal, which is used by the optionholders to tender their securities in the tender offer.
- Other ancillary documents, such as the forms of communications with optionholders that the company intends to use and letters for use by optionholders to withdraw a prior election to participate.

The documents listed above are filed with the SEC as exhibits to a Schedule TO Tender Offer Statement.

The offer to exchange is the primary disclosure document for the repricing offer and, in addition to the information required to be included by Schedule TO, focuses on informing securityholders about the benefits and risks associated with the repricing offer. The offer to exchange is required to contain a Summary Term Sheet that provides general information—often in the form of frequently asked questions—regarding the repricing offer, including its purpose, eligibility of participation, duration and how to participate. It is also common practice for a company to include risk factors disclosing economic, tax and other risks associated with the exchange offer. The most comprehensive section of the offer to exchange is the section describing the terms of the offer, including the purpose, background, material terms and conditions, eligibility to participate, duration, information on the stock or other applicable units, interest of directors and officers with respect to the applicable units or transaction, procedures for participation, tax consequences, legal matters, fees and other information material to the decision of a securityholder when determining whether or not to participate in such offer.

The offer to exchange, taken as a whole, should provide comprehensive information regarding the securities currently held and those being offered in the exchange—including the difference in the rights and potential values of each. The disclosure of the rights and value of the securities is often

¹⁹ On March 21, 2001, the SEC Division of Corporation Finance issued an exemptive order granting exchange offers that meet certain conditions exemption from Rule 13e-4(f)(8)(i) (the “all holders” rule) and Rule 13e-4(f)(8)(ii) (the “best price” rule).

²⁰ An issuer must satisfy a number of requirements in order to be eligible for the relief: (1) the issuer must be eligible to use Form S-8, the options subject to the exchange offer must have been issued under an employee benefit plan as defined in Rule 405 under the Securities Act and the securities offered in the exchange offer will be issued under such an employee benefit plan; (2) the exchange offer must be conducted for compensatory purposes; (3) the issuer must disclose in the offer to purchase the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer and (4) except as exempted in the order, the issuer must comply with Rule 13e-4.

supplemented by a presentation of the market price of the underlying stock to which the options pertain, including historical price ranges and fluctuations, such as the quarterly highs and lows for the previous three years. The offer to exchange may also contain hypothetical scenarios showing the potential value risks/benefits of participating in the exchange offer. These hypothetical scenarios illustrate the approximate value of the securities held and those offered in the exchange at a certain point in the future assuming a range of different prices for the underlying stock. If the repricing is part of an overall shift in a company's compensation plan, the company should include a brief explanation of its new compensation policy.

Launch of the repricing offer. The offer to exchange is transmitted to employees after the Schedule TO has been filed with the SEC. While the offer is pending, the Schedule TO and all of the exhibits thereto (principally the offer to exchange) may be reviewed by the SEC staff who may provide comments to the company, usually within five to seven days of the filing. The SEC's comments must be addressed by the company to the satisfaction of the SEC, which usually requires the filing of an amendment to the Schedule TO, including amendments to the offer to exchange. Generally, no distribution of such amendment (or any amendments to the offer to exchange) will be required.²¹ This review usually does not delay the tender offer and generally will not add to the period that it must remain open.

Under the tender offer rules, the tender offer must remain open for a minimum of 20 business days from the date that it is first published or disseminated. For the reasons noted below, most option repricing exchange offers are open for less than 30 calendar days. If the consideration offered or the percentage of securities sought is increased or decreased, the offer must remain open for at least ten business days

from the date such increase or decrease is first published or disseminated. The SEC also takes the position that if certain material changes are made to the offer (e.g., the waiver of a condition), the tender offer must remain open for at least five business days thereafter.²² At the conclusion of the exchange period, the repriced options, restricted stock or RSUs will be issued pursuant to the exemption from registration provided by Section 3(a)(9) of the Securities Act of 1933, as amended (the "Securities Act") for the exchange of securities issued by the same issuer for no consideration.

Conclusion of the repricing offer. The company is required to file a final amendment to the Schedule TO setting forth the number of optionholders who accepted the offer to exchange.

Certain Other Considerations

Tax Issues

If the repricing offer is open for more than 30 days with respect to options intended to qualify for ISO treatment under US tax laws, those incentive stock options are considered newly granted on the date the offer was made, whether or not the optionholder accepts the offer.²³ If the period is 30 days or less, then only ISO holders who accept the offer will be deemed to receive a new grant of ISOs.²⁴ As discussed above, the consequence of a new grant of ISOs is restarting the holding period required to obtain beneficial tax treatment for shares purchased upon exercise of the ISO.²⁵ As a result of these requirements, repricing offers involving ISO holders should generally be open for no more than 30 days.

In order to qualify for ISO treatment, the maximum fair market value of stock with respect to which ISOs may first become exercisable in any one year is \$100,000. For purposes of applying

21 If the terms of the offer change (e.g., the option exchange ratio is changed) or other material changes are made to the disclosure in the Offer to Exchange, a supplement may need to be prepared, mailed to stockholders, and filed with the SEC as part of a Schedule TO amendment. This rarely occurs in the context of an option repricing.

22 If such change is made at a time when more than five business days remain before the expiration of the tender offer, no extension of the tender offer would be needed. If such change is made in the five business day period preceding the scheduled expiration of the tender offer, an extension would be necessary.

23 Treas. Reg. 1.424-1(e)(4)(iii).

24 *Id.*

25 Treas. Reg. 1.424-1(e)(2).

this dollar limitation, the stock is valued when the option is granted, and options are taken into account in the order in which granted. Whenever an ISO is canceled pursuant to a repricing, any options, any shares scheduled to become exercisable in the calendar year of the cancellation would continue to count against the US\$100,000 limit for that year, even if cancellation occurs before the shares actually become exercisable.²⁶ To the extent that the new ISO becomes exercisable in the same calendar year as the cancellation, this reduces the number of shares that can receive ISO treatment (because the latest grants are the first to be disqualified).²⁷ Where the new ISO does not start vesting until the next calendar year, however, this will not be a concern.

If the repricing occurs with respect to nonqualified stock options, such options need to be structured so as to be exempt from (or in compliance with) Section 409A of the IRC. Section 409A, effective in January 2005, comprehensively codifies for the first time the federal income taxation of nonqualified deferred compensation. Section 409A generally provides that unless a “nonqualified deferred compensation plan” complies with various rules regarding the timing of deferrals and distributions, all amounts deferred under the plan for the current year and all previous years become immediately taxable, and subject to a 20 percent penalty tax and additional interest, to the extent the compensation is not subject to a “substantial risk of forfeiture” and has not previously been included in gross income. While at one time the feasibility of option repricing under Section 409A was in doubt, the final regulations clarify that a reduction in price that is not below the fair market of the underlying stock value on the date of the repricing should not cause the option to become subject to Section 409A. Instead, such repricing of an underwater option is treated as the award of a new stock option that is exempt from Section 409A.²⁸

It should also be noted that a repriced option will be considered regranted for purposes of the performance-based compensation exception to the US\$1 million limitation under Section 162(m)

of the IRC on deductions for compensation to certain named executive officers and will again count against any per-person grant limitations in the plan intended to satisfy the rules governing the exception.²⁹

Accounting Treatment

Accounting considerations are a significant factor in structuring a repricing. Prior to the adoption of FAS 123R in 2005, companies often structured repricings with a six-month hiatus between the cancellation of underwater options and the grant of replacement options. The purpose of this structure was to avoid the impact of variable mark-to-market charges. Under FAS 123R, however, the charge for the new options is not only fixed upfront, but is for only the incremental value, if any, of the new options over the canceled options. As discussed above, in a value-for-value exchange, a fewer number of options or shares of restricted stock or RSUs will usually be granted in consideration for the surrendered options. As a result, the issuance of the new options or other securities can be a neutral event from an accounting expense perspective.

Section 16

The replacement of an outstanding option with a new option having a different exercise price and a different expiration date involves a disposition of the outstanding option and an acquisition of the replacement option, both of which are subject to reporting under Section 16(a). However, the disposition of the outstanding option will be exempt from short-swing profit liability under Section 16(b) pursuant to Rule 16b-3(e) if the terms of the exchange are approved in advance by the issuer’s board of directors, a committee of two or more non-employee directors, or the issuer’s shareholders. It is generally not a problem to satisfy these requirements. Similarly, the grant of the replacement option or other securities is subject to reporting, but will be exempt from short-swing profit liability pursuant to Rule 16b-3(d) if the grant was approved in advance by the board of directors or a committee composed solely of two or more

²⁶ Treas. Reg. 1.422-4(b)(5).

²⁷ Treas. Reg. 1.422-4(b)(3); Treas. Reg. 1.422-4(d), Example 2.

²⁸ Treas. Reg. 1.409A-1(b)(5)(v)(A).

²⁹ Treas. Reg. 1.162-27(e)(2)(vi)(B); Treas. Reg. 1.162-27(e)(2)(vii), Example 10.

non-employee directors, or was approved in advance or ratified by the issuer's shareholders no later than the date of the issuer's next annual meeting, or is held for at least six months.

Foreign Private Issuers

Relief from Shareholder Approval Requirement

Both the NYSE and Nasdaq provide foreign private issuers with relief from the requirement of stockholder approval for a material revision to an equity compensation plan by allowing them instead to follow their applicable home country practices. As a result, if the home country practices of a foreign private issuer do not require shareholder approval for a repricing, the foreign private issuer is not required to seek shareholder approval under NYSE or Nasdaq rules.

Both the NYSE and Nasdaq require an issuer following its home country practices to disclose in its annual report on Form 20-F an explanation of the significant ways in which its home country practices differ from those applicable to a US domestic company. The disclosure can also be included on the issuer's website in which case, under NYSE rules, the issuer must provide the web address in its annual report where the information can be obtained. Under Nasdaq rules, the issuer is required to submit to Nasdaq a written statement from independent counsel in its home country certifying that the issuer's practices are not prohibited by the home country's laws.

A number of foreign private issuers have disclosed that they will follow their home country practices with respect to a range of corporate governance matters, including the requirement of shareholder approval for the adoption or any material revision to an equity compensation plan. These companies are not subject to the requirement of obtaining shareholder approval. Companies that have not provided such disclosure and wish to avoid the shareholder approval requirements when undertaking a repricing will need to consider carefully their historic disclosure and whether such an opt-out poses any risk of a claim from shareholders.

Relief from US Tender Offer Rules

Foreign private issuers also have significant relief from the application of US tender offer rules if US optionholders hold ten percent or less of the options that are subject to the repricing offer. For purposes of calculating the percentage of US holders, the issuer is required to exclude from the calculation options held by any person who holds more than ten percent of such issuer's outstanding options. Under the exemption, the issuer would be required to take the following steps:

- (i) File with the SEC under the cover of a "Form CB" a copy of the informational documents that it sends to its optionholders. This informational document would be governed by the laws of the issuer's home country and would generally consist of a letter to each optionholder explaining why the repricing is taking place, the choices each optionholder has and the implications of each of the choices provided
- (ii) Appoint an agent for service of process in the United States by filing a "Form F-X" with the SEC
- (iii) Provide each US optionholder with terms that are at least as favorable as those terms offered to optionholders in the issuer's home country.

A more limited exemption to the US tender offer rules also exists for foreign private issuers in instances where US investors hold 40 percent or less of the options that are subject to the repricing. Under this exception, both US and non-US securityholders must receive identical consideration. The minimal relief is intended merely to minimize the conflicts between US tender offer rules and foreign regulatory requirements.

Alternative Strategies

In recent years, Microsoft and Google have used innovative methods to address the issue of underwater employee stock options, providing a viable alternative to repricing.

In 2007, Google implemented an ongoing program that affords its optionholders (excluding directors and officers) the ability to transfer outstanding options to a financial institution through a competitive online bidding process managed by Morgan Stanley. The bidding process effectively creates a secondary market in which employees can view what certain designated financial institutions and institutional investors are willing to pay for vested options. The value of the options is therefore a combination of their intrinsic value (i.e., any spread) at the time of sale plus the “time value” of the remaining period during which the options can be exercised (limited to a maximum of two years in the hands of the purchaser). As a result of this “combined” value, Google expects that underwater options will still retain some value. This expectation is supported by the fact that in-the-money options have been sold at a premium to their intrinsic value. Google’s equity incentive plan was drafted sufficiently broadly to enable options to be transferable without the need to obtain shareholder approval to amend the plan. It is likely, however, that most other companies’ plans limit transferability of options to family members. Accordingly, most companies seeking to implement a similar transferable option program will likely need to obtain shareholder approval in order to do so. Finally, it should be noted that ISOs become non-qualified stock options if transferred. The only options Google granted following its IPO were non-qualified stock options and, accordingly, the issue of losing ISO status did not arise.

In 2003, Microsoft implemented a program that afforded employees holding underwater stock options a one-time opportunity to transfer their options to JPMorgan in exchange for cash.³⁰ The program was implemented at the same time that

Microsoft started granting restricted stock instead of options and was open on a voluntary basis to all holders of vested and unvested options with an exercise price of US\$33 or more (at the time of the implementation of the program, the company’s stock traded at US\$26.5). Employees were given a one-month election period to participate in the program, and once an employee chose to participate, all of that employee’s eligible options were required to be tendered. Employees who transferred options were given a cash payment in installments dependent upon their continued service with Microsoft.

The methods used by Google and Microsoft raise a number of tax and accounting questions and require the filing of a registration statement under the Securities Act in connection with short sales made by the purchasers of the options to hedge their exposure. To date, these methods have not been adopted by other companies; however, some larger companies with significant amounts of outstanding, underwater options may want to consider them and investment banks may show renewed interest in offering such programs. Nevertheless, it is likely that most companies will continue to conduct more conventional repricings in order to address underwater options.

Summary

In the face of the recent market downturn, and drawing on lessons learned from the 2001 – 2002 decline in Internet and technology stocks, companies should consider whether they need to address their underwater stock options. A small number of companies have already effected repricings in 2008. With stock prices continuing to be depressed, the last quarter of 2008 is an appropriate time to consider whether to take steps to retain and reincentivize employees. For those companies with a calendar fiscal year, it is the appropriate time to consider whether to seek shareholder approval for a repricing in connection with the company’s 2009 annual meeting.

³⁰ Comcast Corporation implemented a similar program with JPMorgan in 2004. In that case, due to the structure of the option plan, Comcast repurchased the options and issued new options to JPMorgan with exercise prices and times to maturity identical to the repurchased options.

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